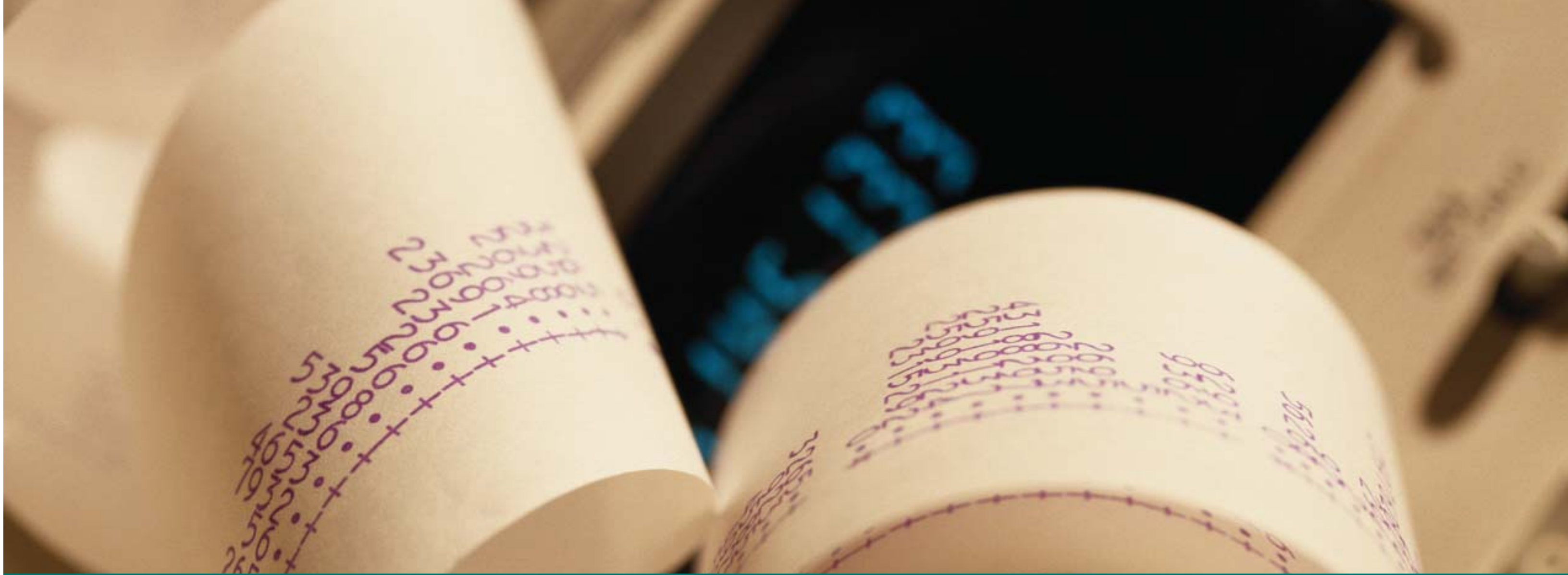

Inspector General's Report on EPA's Fiscal 2006 and 2005 Consolidated Financial Statements

Contents

U.S. Environmental Protection Agency
Office of Inspector General

2007-1-00019
November 15, 2006

At a Glance

Catalyst for Improving the Environment

Why We Did This Audit

We performed this audit in accordance with the Government Management Reform Act, which requires the U.S. Environmental Protection Agency (EPA) to prepare, and the Office of Inspector General to audit, the Agency's financial statements each year. Our primary objectives were to determine whether:

- EPA's consolidated financial statements were fairly presented in all material respects.
- EPA's internal controls over financial reporting were in place.
- EPA management complied with applicable laws and regulations.

Background

The requirement for audited financial statements was enacted to help bring about improvements in agencies' financial management practices, systems, and controls so that timely, reliable information is available for managing Federal programs.

For further information, contact our Office of Congressional and Public Liaison at (202) 566-2391.

To view the full report, click on the following link:

<www.epa.gov/oig/reports/2007/20061115-2007-1-00019.pdf>

Audit of EPA's Fiscal 2006 and 2005 Consolidated Financial Statements

EPA RECEIVES UNQUALIFIED OPINION

We rendered an unqualified, or clean, opinion on EPA's Consolidated Financial Statements for fiscal 2006 and 2005, meaning that they were fairly presented and free of material misstatement.

INTERNAL CONTROL REPORTABLE CONDITIONS NOTED

We noted the two following reportable conditions:

- EPA implemented two accounting processes in fiscal 2006 that led to misstatements of the Agency's fiscal 2006 bad debt expense, revenue, contra revenue, advance accounts, and unearned revenue accounts. The processes included reclassifying receivables older than 2 years as currently not collectible, and transferring the receivables and related allowance accounts from regional financial management offices to financial management centers.
- EPA did not properly account for advance funding agreements with other Federal Government agencies. EPA recorded advances disbursed under Interagency Agreements as expenses instead of as assets. As a result, EPA overstated expenses and understated assets by $55,982,983.

NONCOMPLIANCE WITH LAWS AND REGULATIONS NOTED

EPA is in noncompliance with regulations relating to reconciling intragovernmental transactions. The Agency did not reconcile material activity and balances with the Department of Health and Human Services during the year, and had out of balance situations with many other agencies.

AGENCY COMMENTS AND OFFICE OF INSPECTOR GENERAL EVALUATION

In a memorandum received on November 13, 2006, from the Chief Financial Officer, the Agency agreed with the issues raised and indicated it will take needed corrective actions.

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

November 15, 2006

OFFICE OF
INSPECTOR GENERAL

MEMORANDUM

SUBJECT: Audit of EPA's Fiscal 2006 and 2005 Consolidated Financial Statements
Report No. 2007-1-00019

FROM: Paul C. Curtis
Director, Financial Statement Audits

TO: Lyons Gray
Chief Financial Officer

Attached is our audit report on the U.S. Environmental Protection Agency's fiscal 2006 and 2005 consolidated financial statements. We are reporting a reportable condition and noncompliance with laws and regulations related to EPA's accounting for interagency activity, as well as a reportable condition related to erroneous postings to bad debt expense. Attachment 3 contains the status of recommendations from prior years.

The estimated cost of this report—calculated by multiplying the project's staff days by the applicable daily full cost billing rates in effect at the time—is $2,561,416.

This audit report represents the opinion of the OIG, and the findings contained in this report do not necessarily represent the final EPA position. EPA managers in accordance with established EPA audit resolution procedures will make final determinations on matters in this audit report. Accordingly, the findings described in this audit report are not binding upon EPA in any enforcement proceeding brought by EPA or the Department of Justice. We have no objections to the further release of this report to the public. This report will be available at http://www.epa.gov/oig/.

In accordance with EPA Manual 2750, *Audit Management Process*, you are required to provide us with a written response to the final audit report within 90 days of the final report date. The response should address all issues and recommendations contained in Attachments 1 and 2. For corrective actions planned but not completed by the response date, reference to specific milestone dates will assist us in deciding whether or not to close this report in our audit tracking system.

Should you or your staff have any questions about the report, please contact me at (202) 566-2523, or Melissa Heist, Assistant Inspector General of Audit, at (202) 566-0899.

Attachments

cc: See Appendix III, Report Distribution List

Inspector General's Report on EPA's Fiscal 2006 and 2005 Consolidated Financial Statements

The Administrator
U.S. Environmental Protection Agency

We have audited the consolidated balance sheets of the U.S. Environmental Protection Agency (EPA, or the Agency) as of September 30, 2006 and 2005, and the related consolidated statements of net cost, net cost by goal, changes in net position, financing and custodial liability, and the combined statement of budgetary resources for the years then ended. These financial statements are the responsibility of EPA's management. Our responsibility is to express an opinion on these financial statements based upon our audit.

We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial statements contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; and Office of Management and Budget (OMB) Bulletin 06-03, *Audit Requirements for Federal Financial Statements*. These standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1.J., the Agency changed its accounting for delinquent debts in fiscal 2006 to comply with OMB Circular A-129, Policies for Federal Credit Programs and Non-Tax Receivables.

The financial statements include expenses of grantees, contractors, and other Federal agencies. Our audit work pertaining to these expenses included testing only within EPA. Audits of grants, contracts, and interagency agreements performed at a later date may disclose questioned costs of an amount undeterminable at this time. The U.S. Treasury collects and accounts for excise taxes that are deposited into the Superfund and Leaking Underground Storage Tank Trust Funds. The U.S. Treasury is also responsible for investing amounts not needed for current disbursements and transferring funds to EPA as authorized in legislation. Since the U.S. Treasury, and not EPA, is responsible for these activities, our audit work did not cover these activities.

The Office of Inspector General (OIG) is not independent with respect to amounts pertaining to OIG operations that are presented in the financial statements. The amounts included for the OIG are not material to EPA's financial statements. The OIG is organizationally independent with respect to all other aspects of the Agency's activities.

In our opinion, the consolidated financial statements present fairly, including the accompanying notes, in all material respects, the consolidated assets, liabilities, net position, net cost, net cost by goal, changes in net position, reconciliation of net cost to budgetary obligations, custodial activity, and combined budgetary resources of EPA, as of and for the years ended September 30, 2006 and 2005, in conformity with accounting principles generally accepted in the United States of America.

Review of EPA's Required Supplementary Stewardship Information, Required Supplementary Information, Supplemental Information, and Management's Discussion and Analysis

We inquired of EPA's management as to its methods for preparing Required Supplementary Stewardship Information (RSSI), Required Supplementary Information, Supplemental Information, and Management's Discussion and Analysis, and reviewed this information for consistency with the financial statements. The Supplemental Information includes the unaudited Superfund Trust Fund financial statements for fiscal 2006 and 2005, which are being presented for additional analysis and are not a required part of the basic financial statements. However, our audit was not designed to express an opinion and, accordingly, we do not express an opinion on EPA's RSSI, Required

Supplementary Information, Supplemental Information, and Management's Discussion and Analysis.

We did not identify any material inconsistencies between the information presented in EPA's consolidated financial statements and the information presented in EPA's RSSI, Required Supplementary Information, Supplemental Information, and Management's Discussion and Analysis.

Evaluation of Internal Controls

As defined by OMB, internal control, as it relates to the financial statements, is a process, affected by the Agency's management and other personnel, designed to provide reasonable assurance that the following objectives are met:

- **Reliability of financial reporting:** Transactions are properly recorded, processed, and summarized to permit the preparation of the financial statements and RSSI in accordance with generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.
- **Reliability of performance reporting:** Transactions and other data that support reported performance measures are properly recorded, processed, and summarized to permit the preparation of performance information in accordance with criteria stated by management.
- **Compliance with applicable laws and regulations:** Transactions are executed in accordance with laws governing the use of budget authority and any other laws, regulations, and government-wide policies identified by OMB that could have a direct and material effect on the financial statements or RSSI.

In planning and performing our audit, we considered EPA's internal controls over financial reporting by obtaining an understanding of the Agency's internal controls, determining whether internal controls had been placed in operation, assessing control risk, and performing tests of controls in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements. We limited our internal control testing to those controls necessary to achieve the objectives described in OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*. We did not test all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act of 1982 (FMFIA), such as those controls relevant to ensuring efficient operations. The objective of our audit was not to provide assurance on internal controls and, accordingly, we do not express an opinion on internal controls.

Our consideration of the internal controls over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be reportable conditions. Under standards issued by the American Institute of Certified Public Accountants, reportable conditions are matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the Agency's ability to record, process, summarize, and report financial data consistent with the assertions by management in the financial statements. Material weaknesses are reportable conditions in which the design or operation of internal control does not reduce to a relatively low level the risk that errors, fraud or noncompliance in amounts that would be material in relation to the financial statements or RSSI being audited, or material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Because of inherent limitations in internal controls, misstatements, losses, or noncompliance may nevertheless occur and not be detected. We noted certain matters discussed below involving the internal control and its operation that we consider to be reportable conditions, although none of the reportable conditions is believed to be a material weakness.

In addition, we considered EPA's internal control over the RSSI by obtaining an understanding of the Agency's internal controls, determined whether these internal controls had been placed in operation, assessed control risk, and performed tests of controls as required by OMB Bulletin No. 06-03. Our procedures were not designed to provide assurance on these internal controls and, accordingly, we do not express an opinion on such controls.

Finally, with respect to internal controls related to performance measures presented in *EPA's FY 2006 Performance and Accountability Report*, we obtained an understanding of the design of significant internal controls relating to the existence and completeness assertions, as required by OMB Bulletin No. 06-03. Our procedures were not designed to provide assurance on internal control over reported performance measures and, accordingly, we do not express an opinion on such controls.

REPORTABLE CONDITIONS

Reportable conditions are internal control weaknesses coming to the auditor's attention that, in the auditor's judgment, should be communicated because they represent significant deficiencies in the design or operation of internal controls that could adversely affect the organization's ability to meet the OMB objectives for financial reporting discussed above. In evaluating the Agency's internal control structure, we identified two reportable conditions, as follows:

Implementing Accounting Processes Resulted in Misstatements

EPA implemented two accounting processes in fiscal 2006 that led to misstatements of the Agency's fiscal 2006 bad debt expense, revenue, contra revenue, advance accounts, and unearned revenue accounts. The Agency adopted OMB Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables*, which provides for the reclassification of receivables older than 2 years as currently not collectible (CNC). The Agency's revised CNC transaction posting model was not mapped to the allowance account and did not include an entry to offset the reduction of current year revenue. The combination of subsequent CNC reclassifications and allowance adjustment caused the misstatement of EPA's fiscal 2006 bad debt expense, revenue, contra revenue, and advance accounts. In addition, the Agency transferred the receivables and related allowance accounts from regional financial management offices to financial management centers. Inadvertent increases of allowance accounts and subsequent adjustments to remove the allowance accounts resulted in incorrect postings to bad debt expense, revenue, contra revenue, and unearned revenue accounts.

Misclassified Interagency Agreement Advances to Other Federal Agencies

EPA did not properly account for advance funding agreements with other Federal Government agencies. Though Federal accounting standards and EPA's accounting procedures require that advances made to other agencies be recorded as assets, EPA recorded advances disbursed under Interagency Agreements (IAGs) as an expense. This occurred because the other Federal agencies drew down the funds under the IAGs soon after the funds were obligated. EPA contributed to the problem by not following its own accounting policies or that of the U.S. Treasury. In addition, the Agency has not developed written procedures for recovering advances from other Agencies. As a result, EPA overstated expenses and understated assets by $55,982,983.

We have reported less significant matters regarding internal controls in the form of position papers during the course of the audit. We will not issue a separate management letter.

COMPARISON OF EPA'S FMFIA REPORT WITH OUR EVALUATION OF INTERNAL CONTROLS

OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*, requires us to compare material weaknesses disclosed during the audit with those material weaknesses reported in the Agency's FMFIA report that relate to the financial statements and identify material weaknesses disclosed by the audit that were not reported in the Agency's FMFIA report.

For reporting under FMFIA, material weaknesses are defined differently than they are for financial statement audit purposes. OMB Circular A-123, *Management Accountability and Control*, defines a material weakness as a deficiency that the Agency head determines to be significant enough to be reported outside the Agency.

For financial statement audit purposes, OMB defines material weaknesses in internal control as reportable conditions in which the design or operation of the internal control does not reduce to a relatively low level the risk that errors, fraud, or noncompliance in amounts that would be material in relation to the financial statements or RSSI being audited, or material to a performance measure or aggregation of related performance measures, may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

The Agency did not report, and our audit did not detect, any material weaknesses for fiscal 2006.

Tests of Compliance with Laws and Regulations

EPA management is responsible for complying with laws and regulations applicable to the Agency. As part of obtaining reasonable assurance about whether the Agency's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws and regulations, noncompliance with which could have a direct and material effect on the determination of financial statement amounts, and certain other laws and regulations specified in OMB Bulletin No. 06-03, *Audit Requirements for Federal Financial Statements*. The OMB guidance also requires that we report on EPA's compliance with the Federal Financial Management Improvement Act (FFMIA) of 1996. We limited our tests of compliance to these provisions and did not test compliance with all laws and regulations applicable to EPA.

Providing an opinion on compliance with certain provisions of laws and regulations was not an objective of our audit and, accordingly, we do not express such an opinion. A number of ongoing investigations involving EPA's grantees and contractors could disclose violations of laws and regulations, but a determination about these cases has not been made. In addition, the Agency is changing the confidential financial disclosure forms required to be filed by EPA employees, the forms are for the period October 1, 2005 thru December 31, 2006 and are due February 15, 2007. Since the Agency did not require these forms to be prepared in time to be reviewed for this audit, we did not perform any tests or inquiries about those reports. Had the Agency required the confidential financial disclosure forms be prepared and had we been able to review the reports and perform tests or make additional inquires, matters may have come to our attention that would require reporting.

Our tests of laws and regulations disclosed the following noncompliance issue.

EPA DID NOT RECONCILE DIFFERENCES WITH TRADING PARTNERS

EPA has taken some action to reconcile its intragovernmental activity on a quarterly basis, but did not reconcile differences for intragovernmental transactions with 47 of its trading partners. During the fourth quarter, these differences totaled $518 million. EPA has experienced problems reconciling with its intragovernmental trading partners in prior years, including differences with the HHS that prohibited EPA from fully complying with the applicable U.S. Treasury requirements. In fiscal 2006, we found that HHS records receipts from EPA as deferred revenue while EPA erroneously records disbursements to HHS as expenses when paid, rather than advances. Without confirmation from its trading partners, EPA has limited assurance that intragovernmental balances are accurate. Attachment 2 provides additional details, and our recommendation on actions that should be taken on this matter.

FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT NONCOMPLIANCE

Under FFMIA, we are required to report whether the Agency's financial management systems substantially comply with the Federal financial management systems requirements, applicable Federal accounting standards, and the United States Government Standard General Ledger at the transaction level. OMB memorandum dated January 4, 2001, *Revised Implementation Guidance for the Federal Financial Management Improvement Act*, lists the specific requirements of FFMIA, as well as factors to consider in reviewing systems and for determining substantial compliance with FFMIA. It also provides guidance to Agency heads for developing corrective action plans to bring an Agency into compliance with FFMIA. To meet the FFMIA requirement, we performed tests of compliance with FFMIA section 803(a) requirements and used the OMB guidance, revised on January 4, 2001, for determining substantial noncompliance with FFMIA.

The results of our tests did not disclose any instances where the Agency's financial management systems did not substantially comply with FFMIA requirements.

We reported other less significant matters involving compliance with laws and regulations in position papers during the course of our audit. We will not be issuing a separate management letter.

Prior Audit Coverage

During previous financial or financial-related audits, we reported weaknesses that impacted our audit objectives in the following areas:

- Payroll Internal Controls.
- General Ledger Adjustments for Receivables Transferred to Cincinnati Finance Center (CFC).
- Contingency Plans for Financial Applications.
- Reconciling and reporting intragovernmental transactions, assets, and liabilities by Federal trading partner.
- Recording Marketable Securities.
- Correcting Rejected Transactions.
- Assessing automated application processing controls for IFMS.
- Security Screenings for Non-Federal Personnel.
- Change Control Procedures for IFMS.

Attachment 3, Status of Prior Audit Report Recommendations, summarizes the current status of corrective actions taken on prior audit report recommendations.

Agency Comments and OIG Evaluation

In a memorandum dated November 13, 2006, the Office of the Chief Financial Officer (OCFO) responded to our draft report.

The rationale for our conclusions and a summary of the Agency comments are included in the appropriate sections of this report, and the Agency's complete response is included as Appendix II to this report.

This report is intended solely for the information and use of the management of EPA, OMB, and Congress, and is not intended to be and should not be used by anyone other than these specified parties.

Paul C. Curtis
Director, Financial Audit
Office of Inspector General
U.S. Environmental Protection Agency
November 14, 2006

Attachment 1: Reportable Conditions

1 EPA's Implementation of Accounting Processes Resulted in Misstatements

In fiscal 2006, EPA adopted OMB Circular A-129, *Policies for Federal Credit Programs and Non-Tax Receivables*, which provides for the reclassification of receivables older than 2 years as currently not collectible (CNC). The general ledger automated posting model established by the Agency to record CNC entries reduced the receivables—related revenue or advance account—and recorded the CNC receivables in memo accounts. However, the posting model was not mapped to the allowance accounts and did not include an entry to offset the reduction of current year revenue. The allowance account was subsequently adjusted for decreases in the open accounts receivable due to CNC reclassifications. The combination of the CNC reclassifications and subsequent allowance adjustment caused the initial misstatement of EPA's fiscal 2006 bad debt expense, revenue, contra revenue, and advance accounts. In the fourth quarter, the Agency revised the accounting model to include the allowance account.

In addition, the Agency has been moving its financial operations from the regional FMOs to the finance management centers over the past several years. In fiscal 2006, the receivables and related allowance accounts were transferred from FMOs to financial management centers. Fourth quarter transfers included amounts previously classified by the FMOs as CNC under the original accounting model. By reducing the receivables recorded by the FMOs under the original accounting model, and recording the transfer under the revised accounting model, the allowance accounts were inadvertently increased. Subsequent adjustments to remove the allowance accounts resulted in additional incorrect postings to bad debt expense, revenue, contra revenue, and unearned revenue accounts.

As a result, at the end of fiscal 2006, bad debt expense has a credit balance of $54,792,630 and several revenue accounts have debit balances totaling $9,342,912. The US Standard General Ledger dictates that bad debt expense and contra revenue accounts should normally have a debit balance and revenue accounts should normally have a credit balance. In addition, the advance account for Superfund future cost special account receivables has a debit balance of $2,749,860. The account for advances received from others should normally have a credit balance.

Contents

RECOMMENDATIONS

We recommend the OCFO require the Reporting and Analysis Staff:

1. Make the necessary corrections to properly adjust fiscal 2006 bad debt expense, revenue and advance accounts to their normal balances.
2. Work with finance offices to correct the impact of any future CNC reductions.

We recommend the OCFO have the Financial Management Offices and Finance Centers:

3. Monitor CNC decrease entries to transactions for abnormal increases in the allowance accounts and decreases in revenue.
4. Notify Reports and Analysis Staff of these CNC decrease entries and any allowance for doubtful account decrease entries needed to correct allowance accounts.

AGENCY COMMENTS AND OIG EVALUATION

The Agency generally concurred with our recommendations; however, OCFO only made a partial adjustment to bad debt expense for financial statement purposes. Our analysis indicated that there were entries that created abnormal balances in certain revenue and liability accounts that need to be adjusted.

2 EPA Misclassified Interagency Agreement Advances to Other Federal Agencies

EPA did not properly account for advance funding agreements with other Federal Government agencies. These agreements usually involve the joint funding of expenses, grants or contracts for projects that are administered by another Government agency. Federal accounting standards and EPA's accounting procedures require that advances made to other agencies be recorded as assets that are reduced when goods and services are received, contract terms are met, or progress is made. However, EPA recorded advances disbursed to administering agencies under IAGs as an expense. This occurred because the other Federal agencies drew down the funds under the IAGs soon after the funds were obligated. EPA contributed to the problem by not following its own accounting policies or that of the U.S. Treasury by not ensuring it received support for the funds disbursed under the IAGs. In addition, the Agency has not developed written procedures for recovering advances from other Agencies when they do not provide proper cost documentation on advance agreements. As a result, EPA overstated expenses and understated assets by $55,982,983.

The Treasury Financial Manual Volume 1, Part 2, Chapter 2500, Section 2515.10, *Payments to Other Appropriations and Funds as Reimbursements or Advances*, states:

> *"Advance Payments Required by Law—These transactions are required by a specific law, by which a determined amount is to be transferred from one agency and merged with a specific account of another agency. The amount is payment in advance for goods and services that will be provided by the second agency.*
>
> *Advance Payments to Certain Revolving and Working Capital Funds—These are transactions authorized by law, by which certain revolving and working capital funds are permitted to request payment for goods and services in advance of delivery. These advances represent a liability of the revolving or working capital fund pending delivery of the goods and services.*
>
> *Advance Payments to Management Funds—Management fund accounts are authorized by specific laws to receive advances from appropriations to ease accounting for and administration of intra-governmental activities. These accounts are classified either as annual or no-year accounts, depending on the circumstances.*
>
> *Advance Payments to Consolidated Working Funds—advances for goods and services to be provided within the same fiscal year by the performing agency through use of its own facilities may be made to "consolidated working fund" accounts of the performing agency under Section 601 of the Economy Act, 31 U.S.C. 686. This method of financing reimbursement for goods and services provided by one agency to another should be used only in instances where arrangements for current billings and reimbursements would be impractical."*

Statement of Federal Financial Accounting Standards No. 1, *Accounting for Selected Assets and Liabilities*, dated March 30, 1993, defines advances as cash outlays made by a Federal entity to its employees, contractors, grantees, or others to cover a part or all of the recipients' anticipated expenses. Statement of Federal Financial Accounting Standards No. 1 states that advances should be recorded as assets. The advances should be reduced when goods or services are received, contract terms are met, or progress is made.

A Disbursement Interagency Agreement is an agreement in which another Federal agency delivers goods or services to EPA, and EPA disburses funds to the other agency's account to pay for that agency's expenses. EPA Resource Management Directives 2550c, Paragraphs 6. a. and b. define the methods of payment for goods or services under disbursement IAGs.

> *"a. Reimbursable Payment. The agency performing the work specified in the agreement periodically bills the other agency or agencies who are party to the agreement for amounts obligated or costs incurred in providing the services or goods. The agency is then reimbursed by the other agencies for those costs.*
>
> *b. Advance Payment. Some agencies which perform work on a reimbursable basis must receive pay-*

ment for the provision of goods or services in advance, i.e., before they actually incur costs. In this arrangement, the agency requesting the work provides advance payment to the other agency; these funds are placed in the other agency's working fund account. As work is performed, the agency doing the work will report its expenditures on a regular basis to the agency requesting the work. The requesting agency is then able to liquidate the advance payment in its accounting records."

During disbursement testing at CFC, we identified an advance funded IAG in our sample universe that was misclassified in IFMS. Based on the results of that testing, we expanded our review to look at all EPA advance IAGs with other Federal agencies. The review included data retrieved from the Integrated Grants Management System that identified EPA IAGs with other Federal agencies that were marked "advance" funded. From the search of the Integrated Grants Management System and discussions with EPA project officers and grant specialists, CFC verified which IAGs were truly advance funded. Then they tried to determine the status of those IAGs by obtaining progress reports with supporting cost detail. Where available, CFC used the most recent progress reports that included supporting cost detail from its files. CFC reviewed the detailed cost documentation to try to determine total advances, expenditures incurred to date, and the remaining outstanding advance for the advance funded IAGs. Based on this review CFC identified IAG advances totaling $55,982,983 that were misclassified as operating expenses.

Payments made under disbursement IAGs are typically processed with transaction codes and types that record transactions as operating expenses. We found that CFC recorded the entire $55,982,983 of advance payments to other Federal agencies as operating expenses rather than as advances. Further, CFC did not originally record the advance payments as an advance in fiscal 2006, and did not follow up on the status of the outstanding advance. As a result of CFC recording advances as expenses, expenses were overstated by $55,982,983.

RECOMMENDATIONS

We recommend the OCFO have the CFC:

5. Ensure all future payments under advanced funded disbursement IAGs are recorded as advances, and expenses are recognized in the period incurred.

We recommend the OCFO:

6. Establish written procedures for recovering advances from other agencies when those agencies fail to provide proper and timely supporting documentation of the funds being used.

AGENCY COMMENTS AND OIG EVALUATION

The CFO generally agreed with our recommendations, agreeing to coordinate efforts with the Office of Grants and Debarment to strengthen procedures when entering into agreements with other Federal entities so that both entities will be able to accurately compile financial reporting information. However, the OCFO stated they have written policies and procedures in place governing intragovernmental transactions, and will refine them after issuance of OMB business rules governing such transactions. OCFO volunteered to participate on the government-wide committee designed to resolve trading partner issues among agencies.

Attachment 2: Compliance with Laws and Regulations

3 EPA Did Not Reconcile Differences With Trading Partners

Contents

EPA has taken some action to reconcile its intragovernmental activity on a quarterly basis, but has not reconciled differences for intragovernmental transactions with 47 of its trading partners. During the fourth quarter, these differences totaled $518 million. EPA has experienced problems reconciling with its intragovernmental trading partners in prior years, including being unable to reconcile differences with the HHS that prohibited EPA from fully complying with the applicable U.S. Treasury requirements. In fiscal 2006, we found that HHS records receipts from EPA as deferred revenue, while EPA erroneously records disbursements to HHS as expenses when paid, rather than advances. Without confirmation from its trading partners, EPA has limited assurance that intragovernmental balances are accurate.

Of the 47 trading partners with differences, we identified three with material differences, as shown below. Two of the three, DHS and HHS, had outstanding material differences for each quarter of fiscal 2006.

Federal Agency	Difference	Category of Difference
Department of Treasury General Fund	$237 million	Not Assigned to Any Category
Department of Homeland Security	$204 million	Unbilled Accounts Receivables/Revenue
Department of Health and Human Services	($96 million)	Advances from Other Agencies
Other Federal Agencies	$173 million	Various Categories

The U.S. Treasury's *Federal Intragovernmental Transactions Accounting Policies Guide* (July 2005) provides Government-wide accounting policies for Federal agencies to account for and reconcile intragovernmental transactions. The Guide states that agencies should reconcile and confirm intragovernmental activity and balances with their trading partners before submitting year-end data and reporting it in audited financial statements. The Guide also provides tools (procedures and examples) to facilitate quarterly reconciliation of intragovernmental activities.

Intragovernmental transactions have been classified by the Government Accountability Office as a Government-wide internal control weakness due to the lack of standardization in recording and processing intragovernmental activities. To resolve the issue, OMB established standard business rules (Memorandum M-03-01, October 4, 2002) to be used in intragovernmental exchange activities. OMB Circular A-136, *Financial Reporting Requirements*, which was updated July 24, 2006, requires Federal agencies to report intragovernmental assets, liabilities, revenue, and certain reporting entities with their trading partners. This information is presented in the financial statements, the Closing Package, and should be in agreement with line items reported on the balance sheet. Intragovernmental balances and transactions are a key component in the consolidation of the financial information submitted by Federal entities and in the overall compilation process of the government-wide financial report.

Since FY 2003 we have reported the need to reconcile differences with HHS as a noncompliance issue. The Agency has not acted to reconcile its intragovernmental activity on a quarterly basis with HHS, causing these differences to continue. EPA should increase its efforts to resolve these differences.

RECOMMENDATION

We recommend the OCFO:

7. Require the Office of Financial Management to reconcile the Agency's intragovernmental transactions to comply with Federal financial reporting requirements.

AGENCY COMMENTS AND OIG EVALUATION

OCFO agreed with our recommendation.

Attachment 3: Status of Prior Audit Report Recommendations

EPA's position is that "audit follow-up is an integral part of good management," and "corrective action taken by management on resolved findings and recommendations is essential to improving the effectiveness and efficiency of Government operations." The Chief Financial Officer is the Agency Follow-up Official and is responsible for ensuring that corrective actions are implemented. In fiscal 2006, OCFO included in its Organizational Assessment Measures a metric for audit follow-up. OCFO management regularly reviews these measures during OCFO's monthly Budget and Performance Review meetings.

The Agency has continued to make substantial progress in completing corrective actions from prior years. The status of issues from prior financial statement audits, that have corrective actions in process, are listed in the following table.

AUDIT ISSUE AREAS WITH CORRECTIVE ACTIONS IN PROCESS
Automated Application Processing Controls for IFMS:
EPA has made progress towards replacing IFMS. However, until EPA implements the planned replacement automated accounting system that addresses past issues, we will continue to disclose a reportable condition concerning documentation of the current accounting system and its automated application processing controls.
EPA Needs to Strengthen Practices Regarding Security Screening for Non-Federal Personnel:
EPA had not completed the remaining actions in the Agency's fiscal 1999 Remediation Plan by the end of fiscal 2006. However, EPA reported that in October 2006 it published the Personal Identity Verification Handbook, which outlines procedures for conducting background investigations for non-Federal workers. We will schedule a review to evaluate the effectiveness of the Agency's implemented procedures.
EPA Did Not Promptly Record Marketable Securities:
The Agency plans to transfer the processing of marketable securities to the Cincinnati Finance Center (CFC) in January 2007. As part of the transfer, CFC will develop a reconciliation procedure to ensure a proper and complete non-cash asset balance.
EPA Continues to Experience Difficulties in Reconciling Intragovernmental Transactions:
The Agency has been working to reconcile Intragovernmental Transactions, however, as described in attachment 2, Compliance with Laws and Regulations, the Agency still has reconciling differences with many other Federal Government Agencies.
Weaknesses in Change Control Procedures for Integrated Financial Management System:
EPA had not completed the remaining corrective action needed by the end of fiscal 2006. However, EPA reported that in October 2006 it finalized the ENDEVOR security plan that documents the system's implemented security controls. We will schedule a review to evaluate the effectiveness of the Agency's implemented procedures.
EPA Should Improve Payroll Internal Controls:
EPA has made progress towards improving payroll internal controls to reduce default payments to current and separated employees. However, EPA has not implemented an automated control in PeoplePlus to limit the number of consecutive default payments. EPA plans to complete the remaining action by December 31, 2006.
EPA Needs to Improve Correction of Rejected Transactions:
EPA had not completed the remaining action needed by the end of fiscal 2006. However, EPA published on November 1, 2006, formal procedures for managing rejected payroll transactions between PeoplePlus and IFMS. We will schedule a review to evaluate the effectiveness of the Agency's implemented procedures.
EPA Needs to Improve Contingency Plans for Financial Applications:
Although EPA has made some progress in correcting this reportable condition, EPA still needs to (1) finalize contingency plans for all OCFO applications not subscribing to the National Computer Center Disaster Recovery Services Plan, and (2) update the personnel contact information within the NCC Critical Application Disaster Recovery Plan. OCFO plans to complete the first action by December 31, 2006. OCFO requested NCC update the Critical Application Disaster Recovery Plan.

UNITED STATES ENVIRONMENTAL PROTECTION AGENCY
WASHINGTON, D.C. 20460

OFFICE OF THE
CHIEF FINANCIAL OFFICER

November 13, 2006

MEMORANDUM

SUBJECT: Draft Audit Report: Response to Audit of EPA's FYs 2006 and 2005 Financial Statements

FROM: Lyons Gray
Chief Financial Officer

Lyons Gray

TO: Bill Roderick
Acting Inspector General

My staff and I thank you for the opportunity to respond to the Draft Audit Report of the U. S. Environmental Protection Agency's FYs 2006 and 2005 Financial Statements. We agree with the issues raised and have some observations and clarifications to offer. These are provided in the attachment.

We believe our existing controls, policies and procedures are effective. We are in the final stages of consolidating several financial functions that will improve our efficiency and effectiveness and have already assisted in streamlining the audit process. As with anything new, challenges exist, but we are currently evaluating ways to improve operations without compromising fiscal integrity.

This year was a model year for both of us. We worked closely implementing some of the best practices in Government, which resulted in a smoother audit process. We thank you for your commitment and diligence.

We look forward to another productive year working with the Office of Inspector General. If you have any questions, please contact Lorna McAllister, Director of the Office of Financial Management at 202-564-4905.

Attachment

cc: Melissa Heist
Paul Curtis
Maryann Froehlich
Joshua Baylson
Lorna M. McAllister
Iantha Gilmore
Milton Brown
Raffael Stein

Attachment I: OCFO's Response to the FY 2006 and FY 2005 Draft Audit Report

INTRODUCTION

We offer the following observations and clarifications:

- The transfer of receivables to the Finance Centers started in FY 2004 and continued into FY 2006. EPA was consolidating processes for efficiency, consistency, and improved internal controls. The consolidation did not cause changes in accounting processes or internal controls.
- As part of the transition, we concede that transferring the receivables from the regions to Cincinnati could have been executed more effectively.
- Consolidating accounting functions and reclassifying debt over two years old consistent with OMB Circular A-129 and Treasury guidance during FY 2006 contributed to the unanticipated abnormal account balances including the year-end bad debt expense account.
- Each quarter EPA works to reconcile differences reported by the Department of Treasury with our major trading partners. As a result of our preliminary review of the 4th quarter Treasury Intragovernmental Activity Report, OCFO identified potential adjustments that will reduce the total unreconciled difference from $518 million to $231 million.

REPORTABLE CONDITIONS

1. *EPA's Implementation of Accounting Processes Resulted in Misstatements*

OIG Recommendation 1: We recommend the OCFO require the Reporting and Analysis Staff: Make the necessary corrections to properly adjust fiscal 2006 bad debt expense, revenue and advance accounts to their normal balances.

OCFO Response: OCFO agrees. OCFO's review determined that only the bad debt expense account required an adjustment. This adjustment was made for financial statement purposes and will be posted in the accounting system in FY 2007.

OIG Recommendation 2: We recommend the OCFO require the Reporting and Analysis Staff: Work with finance offices to correct the impact of any future Currently Not Collectible (CNC) reductions against entries originally recorded in the first through third quarters of fiscal 2006.

OCFO Response: OCFO believes that the recommendation should be modified to end after the word "reductions." An analysis was completed on all fiscal 2006 CNC activity. For FY 2007, the accounting model will be re-evaluated and the impact will be monitored.

OIG Recommendation 3: We recommend the OCFO have the Financial Management Offices and Finance Centers: Continually monitor CNC decrease entries to transactions originally recorded in the first through third quarters of fiscal 2006 for abnormal increases in the allowance accounts and decreases in revenue.

OCFO Response: OCFO believes that the recommendation should delete the words "continually" and "originally recorded the first through third quarters of fiscal 2006." OCFO will formally monitor these transactions monthly instead of quarterly.

OIG Recommendation 4: We recommend the OCFO have the Financial Management Offices and Finance Centers: Notify Reporting and Analysis Staff of these CNC decrease entries and any allowance for doubtful account decrease entries needed to correct allowance accounts.

OCFO Response: OCFO will revise the appropriate accounting models and amend the CNC policy.

2. *EPA Misclassified Interagency Agreement Advances to Other Federal Agencies*

OIG Recommendation 5: We recommend the OCFO have the CFC: Ensure all future payments under advanced funded disbursement IAGs are recorded as advances and expenses are recognized in the period incurred.

OCFO Response: OCFO will coordinate efforts with the Office of Grants and Debarment to strengthen procedures when entering into advance agreements with other federal entities. Such agreements will establish terms and conditions within the IAG process, so that both entities will be able to compile complete, accurate and timely financial information for reporting and recognizing revenue and expenses in the proper period.

OIG Recommendation 6: We

recommend the OCFO: Establish written procedures for recovering advances from other agencies when those agencies fail to provide proper and timely supporting documentation of the funds being used.

OCFO Response: OCFO has written policy and procedures in place governing intragovernmental transactions with trading partners. These policies and procedures will be refined after issuance of OMB business rules (expected by early calendar year 2007) with stringent requirements governing the accounting for intragovernmental transactions including the appropriate handling of advances and other accounting transactions. In addition, OCFO volunteered to participate on the government-wide committee designed to resolve trading partner issues among agencies.

COMPLIANCE WITH LAWS AND REGULATIONS

3. *EPA Did Not Reconcile Differences with Trading Partners*

OIG Recommendation 7: We recommend the OCFO: Require the Office of Financial Management to reconcile the Agency's intragovernmental transactions to comply with Federal financial reporting requirements.

OCFO Response: OCFO agrees with the recommendation and will continue to make progress in this area. The Office of Financial Services will work with the appropriate EPA offices and other federal agencies to obtain the necessary documentation to support these transactions.

Appendix III: Report Distribution List

Chief Financial Officer, Agency Follow-up Official
Assistant Administrator for Administration and Resources Management
Assistant Administrator for Environmental Information
Director, Office of Policy and Resources Management, Office of Administration and Resources Management
Director, Office of Grants and Debarment
Director, Office of Technology Operations and Planning
Director, Office of Budget
Director, Grants Administration Division
Director, Office of Administrative Services
Director, Office of Financial Management
Director, Office of Financial Services
Director, Cincinnati Finance Center
Director, Las Vegas Finance Center
Director, Reporting and Analysis Staff
Director, Financial Systems Staff
Director, Financial Policy and Planning Staff
Director, Washington Finance Center
Agency Follow-up Coordinator
Audit Liaison for the Office of Chief Financial Officer
Audit Liaison for the Office of Administration and Resources Management
Audit Liaison for the Office of Solid Waste and Emergency Response
Audit Liaison for the Office of Administrative Services
Audit Liaison for the Office of Environmental Information
Audit Liaison for the Office of Enforcement and Compliance Assurance
Audit Liaison for the Grants Administration Division
Audit Liaison for the Office of the Administrator
Audit Liaison for the Offices of Financial Management and Financial Services
Office of General Counsel
Acting Inspector General

Abbreviations

CFC	Cincinnati Finance Center
CNC	Currently Not Collectible
EPA	U.S. Environmental Protection Agency
FFMIA	Federal Financial Management Improvement Act
FMFIA	Federal Managers' Financial Integrity Act
FMO	Financial Management Office
IAG	Interagency Agreement
IFMS	Integrated Financial Management System
HHS	Heath and Human Services
OCFO	Office of the Chief Financial Officer
OIG	Office of Inspector General
OMB	Office of Management and Budget
RSSI	Required Supplementary Stewardship Information